



Investment Strategies & Insights

2nd Quarter 2008

The More Things Change...The More They Stay The Same

At the end of the first quarter, we discussed in great detail how volatile the financial markets had become as those that hope the worst is over were doing battle with those that fear there is more to come. It is evident that that battle is still being fought with stocks rallying off their March lows, with the S&P 500 up almost 12% from the bottom by mid May. Since then the downtrend returned with stocks falling back to the March lows, confirming that we are still in a Bear market.

These sharp moves, both up and down, should not surprise us since most of the biggest short-term rallies in stocks have occurred during longer-term down markets. The reason is that when things look the worst it brings out the market pundits claiming that it must be a bottom and it is time to buy. The same is true today, with Citigroup being a classic example. In December 2006, Citigroup was trading at its high of \$56 and by March 2008 had fallen -67% to \$18.62 due to all of the losses in sub-prime mortgage activities. When the largest bank in the U.S. has lost 2/3 of its value it must be a great buying opportunity. From that point "bottom fishers" began to buy the stock and it rallied 40% to \$26.60. Unfortunately, there has been more bad news and Citigroup has fallen further to \$16.45...now -71% from its high.

During market cycles such as these, the more things change the more they stay the same...until there is a real reason for change to be sustainable.

Struggling To Gain Traction

When the economy begins to stall, the powers that be spring into action. Some of the action is simply for the sake of appearing to be doing something, like the tax rebate checks to stimulate consumer spending. Other actions have substance and have been time tested tools for creating economic growth, such as interest rate cuts by the Federal Reserve. At present, the rate cuts that are intended to increase the availability of funds to banks for lending are not having the desired effects. The reason is that banks are still struggling to determine the true value of their mortgage holdings so that the credit markets can finally reach a bottom. Liquidity does not do anything when lenders are hoarding cash and are fearful of each other's sub-prime problems. The result is that the normal control and impact the Fed has over these conditions is diminished.

The other factor that is making the economic recovery difficult is energy prices and the resulting inflation that is showing up at the pump. The higher cost of transportation is impacting food prices as well. With the consumer being bombarded each day with constant reminders of higher prices, consumer sentiment is at historic lows. The combination of higher inflation, flat economic growth, and slowing consumer spending has put the Federal Reserve in a difficult spot. At the present, the Fed appears to be more willing to endure higher inflation by keeping interest rates low and hope that slowing demand will force prices lower while the economy has time to recover.

This is definitely a balancing act that Fed Chairman Bernanke is trying to negotiate, with the added pressure of being in a Presidential election year. In order to protect their jobs Federal Reserve governors need to get the economy growing. Otherwise, the public blames the politicians, and the politicians blame the Fed. Inflation is a real concern for the Federal Reserve but the essence of their current policy is hoping that it will go down. In order for the financial markets to stabilize and begin a new uptrend, the paradoxes within the economy and the capital markets have to be resolved. Inflation must be curbed while the economy begins to grow. A growing economy will allow the Fed to fight inflation by raising interest rates, but the banks have to get back in the game first.

"A wise man proportions his beliefs to the evidence."

David Hume, 1777

SUMMARY:

Volatility in the markets continues as rallies have soon turned into retreats.

Problems continue in the credit markets with banks being more concerned with balance sheets than lending.

Surging oil prices are putting pressure on not only the U.S. consumer but the global economy as well.

The energy crisis is the result of many factors and a reasoned policy is needed to both increase supplies and create alternatives.

Oil prices could slide back from the highs if demand continues to decline and supplies are increased by higher Saudi output.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- The Federal Reserve held short-term interest rates steady at 2% at their last meeting signaling that inflation is becoming a greater concern.
- Personal experience suggests a higher inflation rate since food and energy transactions are more frequent, but when the value of purchases compared to total expenditures is considered, actual inflation is lower.
- The financial markets are projecting that the Fed will increase rates by year end, but unless the housing market stabilizes and there is a return to normalcy in the credit markets, this timeline may be too aggressive.

Economic Output and Direction

- The economy continues to show signs of slowing with energy costs providing a major headwind.
- 1st quarter economic output (GDP) was revised to +1%, but current estimates for 2nd quarter are lower at ½%.
- The global economy is beginning to slow as well due in part to lower demand from the U.S. and increasing commodity prices.

Business and Consumer Indicators

- U.S. manufacturers have been the beneficiaries of continued weakness in the dollar making our goods cheaper to other countries.
- However, increasing costs and slowing global demand could begin to squeeze profit margins in the near future.
- Wages have continued to increase at 4% annual rate, but consumer sentiment is at historic lows and is reflected in a flattening of consumer spending.
- The productivity of U.S. workers has continued to rapidly increase, allowing companies to offset higher costs and keep earnings from rapidly deteriorating.
- If this trend cannot be maintained, then pressure on the labor markets will increase, as companies will be forced to cut payrolls.
- The consumer remains the key to the strength, or weakness, of the U.S. economy since 70% is related to personal spending and increased consumer expenditures will be a sign that economic recovery is beginning.

Inside The Markets

The Stock Markets

- The markets continue to look for good news in the midst of a perfect storm of high oil prices and continued losses in companies tied to the credit markets.
- Increased levels of volatility continue to be the norm, especially in the financial stocks.
- Within the S&P 500, 2nd quarter earnings are expected to be down 9% for the year, but with a 53% drop in Financial companies and a 23% rise in Energy companies revealing a huge variance.
- With these disparities, it will be difficult for the broad market to sustain a rally.
- Consequently, we believe that maintaining a defensive posture in our equity positions is warranted.

The Bond Markets

- Treasury bonds remain overvalued with yields falling below 4%, but this is not uncommon during times of economic weakness or financial stress.
- When signs of the economic recovery are apparent it will be time to increase allocations to quality corporate bonds, but we believe that it is too early to implement that strategy.
- At present, maintaining high quality positions in Government and Municipal bonds is our core strategy.
- Recent actions by foreign central banks to raise interest rates, as well as a slight rally in the dollar, has put pressure on foreign bond prices.
- However, we believe that emerging market debt will remain strong, especially in the Asian countries.

Commodities / Alternatives

- The continued rise in commodity prices was recently interrupted by a sharp sell-off, but the long-term trend remains intact.
- However, we believe that volatility in prices will remain high and we are exploring strategies to minimize exposure to these wild swings.
- Alternative energy is a political hot button and the flow of capital investment into this area should only increase over time.
- The same should hold true for infrastructure, both domestic and abroad.



In the book, “Freakonomics”, Steven Levitt provided a very simple, but revealing definition of economics. He stated that at its heart, economics is a system of incentives and disincentives...and when either reaches a certain point, behavior changes. It is with that understanding that the current “energy crisis” should be explored and put into the proper perspective.

It is impossible to watch any news program without some expert or politician opining on the cause or solution to \$4 gasoline. The reason that the opinions vary is that it is not only a complex problem, but there are often agendas that override a rational approach to the issue. The parabolic rise in oil prices is a reflection of a multitude of factors that when combined has created an asset bubble.

The primary cause of price changes in any asset is supply and demand. Over the long run, the old economists’ cliché, ‘that the solution to higher prices is higher prices’ holds true here. When disincentives become painful enough, behavior will change, leading to lower demand and falling prices.

Oil supplies have been increasing at 2% per year for the last five years and that has not kept up with the strong demand growth from the emerging economies. But a price jump of 100% over the last year is not the result of a supply shortage alone. The decline in the value of the U.S. dollar, the currency in which oil is purchased, over the last twelve months has been one of the culprits. Without the fall, a barrel of oil would cost less than \$110 today rather than the recent \$140 price.

Much has been said of the role of speculators in driving oil prices up, but it is one of the most difficult factors to measure and to control. There is no doubt that investors have poured billions into oil contracts and profited from the rise, but oil futures are driven more by fear and uncertainty than anything else. If the government restricts access to these markets in the U.S., the money will simply move to foreign market and solve nothing.

The reality is that the cause of the dramatic rise in energy costs is multi-faceted and over time the markets will respond to both incentives and disincentives and prices will respond accordingly. In the same manner, the long-term solution to the problem is to reduce dependence on oil, and that requires a coherent and diverse energy strategy. Increasing the supply of oil will bring prices down and allow the time required to pursue and increase alternatives.

The energy crisis is real and it is not only impacting all of us, but it is reaching a “choking point” for the global economy. The current fears of inflation may be warranted for the short-term, but in the long run, energy prices at this level will lead to deflation as they begin to drag down the world economy.

There are encouraging signs that the spike in oil prices could fall back as demand is already weakening and supplies are rising. In addition, in the emerging countries, specifically China, current subsidies that keep fuel costs low are being reduced. This will further reduce demand if Saudi Arabia is able to boost output as they have been promising.

A major drop in oil prices would be very positive for stocks and bonds. The markets would revise down interest rate expectations as inflation fears subsided, and stocks should rally. However, very cheap oil will not be the case until we find a cheaper adequate replacement. Excesses in the markets, no matter what they are, are difficult to work through since the solutions are not simple and are often painful. But pain changes behavior and opportunities abound when the excesses have been wrung out of the markets and the trend shifts. We will be watchful for the shifting of the winds and hope that soon it will be at our backs again.

Best regards,

Craig Greenway

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